NERA
ECONOMIC CONSULTING

Faten Sabry, PhD
Chair of Global Securities and Finance Practice
and Managing Director

National Economic Research Associates, Inc.
1166 Avenue of the Americas
New York, New York 10036
+1 212 345 3000 Fax +1 212 345 4650
Direct dial: +1 212 345 3285
faten.sabry@nera.com
www.nera.com

August 29, 2022

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

RE: Docket No. R–1775, RIN 7100–AG34, Regarding Regulation Implementing the Adjustable Interest Rate (LIBOR) Act

Dear Sir/Madam:

We appreciate the opportunity to provide comments regarding the regulation implementing the Adjustable Interest Rate (LIBOR) Act.

I write this letter on behalf of myself and my colleagues Ignacio Franceschelli and Ramisa Roya who co-authored with me an article titled "How Will the LIBOR Transition Affect Mortgage Consumers?", 2022.

I am a Managing Director in the Securities and Finance Practice at NERA and Chair of the Global Securities and Finance Practice. I have over twenty years of experience in economic and financial consulting in the valuation of fixed income securities, derivatives, illiquid assets, businesses and litigation settlements. I received my Ph.D. from Stanford University and have been designated by the American Statistical Association as an Accredited Professional Statistician.

My colleague Ignacio Franceschelli is a Ph.D. economist from Northwestern University and Associate Director at NERA's Securities and Finance Practice. He specializes in the analysis of complex securities including mortgage-backed securities and collateralized debt obligations. He has managed projects involving RMBS and CDO litigation and his work comprises sampling design, econometric models to estimate future collateral losses, and estimation of damages.

Ramisa Roya is a Senior Analyst at NERA's Securities and Finance Practice. She specializes in the analysis of fixed income securities, including mortgage-backed securities. She has provided consulting work and support to expert testimony related to RMBS litigation and mass tort matters and has worked on valuation and estimation of damages in various securities and finance cases. She received her BA in Mathematics and Economics from New York University.

We understand that the LIBOR Act prescribes the following spread adjustments based on the tenor of LIBOR: 0.644 basis points (bps) for overnight LIBOR, 11.448 bps for one-month LIBOR, 26.161 bps for three-month LIBOR, 42.826 bps for six-month LIBOR, and 71.513 bps for 12-month LIBOR. These spread adjustments are based on the historical median difference between LIBOR and SOFR over a 5-year lookback period.

There are limitations to using an adjustment based on historical medians, including 5-year medians, as the basis for setting the spread between LIBOR and SOFR. Our empirical analysis documents the limitation of the proposed adjustment for consumer loans in a recent study (to obtain a copy of the paper, see link). Our study examined the differences between LIBOR and the other benchmark rates which is embedded in the historical pricing of about one-million adjustable mortgage loans that originated between 2005 and 2007. Our analysis demonstrates that mortgage lenders have usually set the prices of adjustable-rate loans based on the contemporaneous differences of the benchmark indices and not the differences between the benchmarks over a historical 5-year lookback period. Our main conclusions are summarized below.

The data we used in the study on mortgage originations presents a real-world example to determine whether the pricing of mortgage loans is best reflected by the contemporaneous or by the 5-year lookback period differences between the different benchmarks. In 2005, mortgage lenders applied higher margin values to loans tied to MTA and COFI, which had lower contemporaneous values than LIBOR even though the 5-year lookback period medians were higher than LIBOR. Similar results are obtained if we focus instead on 2006 or 2007 originations. This means that an adjustment based on a 5-year lookback period would generate loan rates that are not consistent with how loans rates based on different benchmarks have been determined.

Data on mortgage loans from 2005 through 2007 show that the average difference in total interest between loans indexed to LIBOR ranges from 4 to 33 basis points as compared to loans indexed to MTA and 1 to 53 basis points compared to loans indexed to COFI when focusing on the contemporaneous or spot rates for the benchmarks. The study then examines the difference in total interest between loans indexed to LIBOR, MTA, and COFI using a 5-year lookback period as proposed by ARRC. A historical lookback adjustment results in notable inconsistencies in the prices of the mortgage loans between loans indexed to LIBOR as compared with MTA or COFI. An adjustment using a 5-year lookback results in an average difference ranging from 57 to 104 basis points in total interest between LIBOR and MTA-indexed loans, and 108 to 165 basis points average difference in total interest between LIBOR and COFI-based loans.

The methodology used to adjust the spread of mortgage and other consumer loans will have direct effects on various parties, including borrowers, lenders, investors, and intermediaries, and would lead to conflicts of interest. On 30 June 2022, the 5-year lookback period median difference between 6-month LIBOR and 30-day average SOFR was 30 basis points, and the contemporaneous (spot) difference between the two rates was 185 basis points—1.55 percentage points higher. The use of a 5-year lookback period for the transition of mortgages loans which are tied to 6-month LIBOR to SOFR, for example, could lead to conflicts of interest as mortgage payments will vary notably relative to an adjustment where the spread is based on the spot difference between 6-month LIBOR and SOFR (the 30-day average).

Yours Sincerely,

Faten Sabry
Managing Director

Ignacio Franceschelli
Associate Director

Ramisa Roya
Senior Analyst